*February 2010*

***SA141 Short-Term Forecast for the Japanese Economy (2010/1-3—2012/1-3)***

# *Recovery Continues, but with Little Momentum*

## *- Exports Lead the Way, but Domestic Demand Is Sluggish*
## *- Hiking the Consumption Tax Can Break Through the Prevailing Pessimism*

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- Business turns for the better with a boost from emerging economies
- Domestic and external risks exist, such as deindustrialization and market instability
- Action is urgently required to break through a three-cornered deadlock involving companies, households, and the government

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Japan’s economy is clearly picking up. The emerging economies staged a quick recovery, and now the developed countries’ economies are bottoming out. Japanese exports are continuing to expand at a fairly fast pace, and improvements can be seen in production, corporate profits, and business mind, especially in the manufacturing sector. However, private demand is still stagnant. Capital investment remains sluggish and consumer spending is weak as a whole except durable goods supported by policy measures.

Let me begin by summing up the recent changes in domestic and external conditions. Overseas, the business upturn in the emerging countries has picked up more strongly than expected and is serving as an engine for the global economy. Some emerging economies even appear to be overheating. Norway, Australia, and other resource-rich countries are front runners in raising their interest rates, and China and India are fine-tuning their easy monetary policies.

The international financial markets remain instable. Even slight adjustments in Chinese monetary policies have triggered market overreactions. Against the backdrop of a series of shocks—concern about the creditworthiness of a state-owned corporation in Dubai, doubts about the sustainability of the fiscal situation of Greece and other neighboring countries, and the unveiling of a new financial regulation proposed by US President Barack Obama—the yen has appreciated against not just the dollar but also the euro.

At home, with deflation prevailing, the debate concerning deflation has heated up among the public as well as in the government. I describe this situation as "inflation of the deflation debate." As the yen made gains in the wake of the Dubai shock, the Bank of Japan announced new measures to enhance easy monetary conditions, and the government introduced another stimulus package.

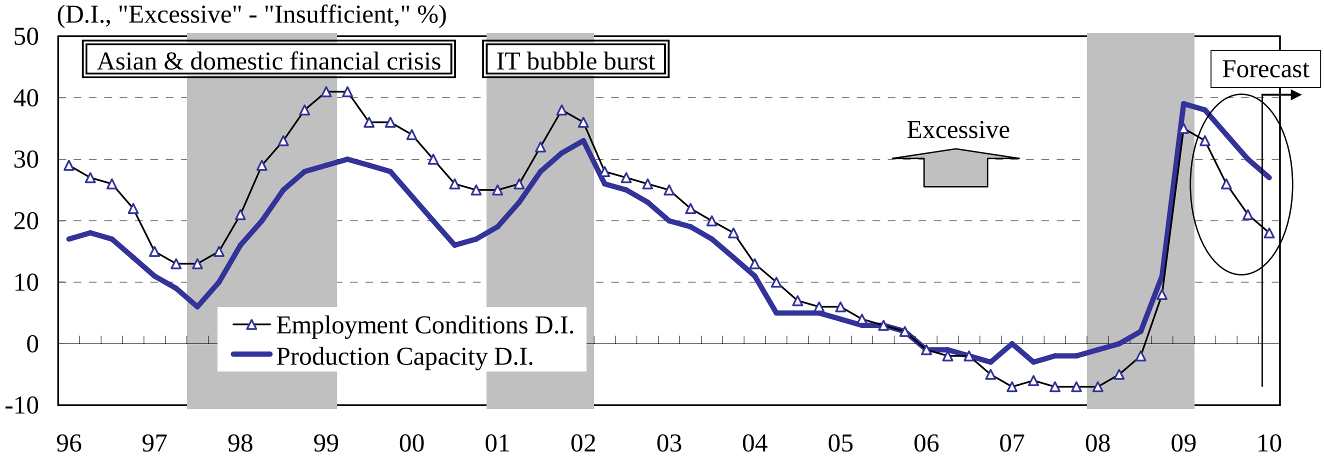
Japan's national budget for fiscal 2010 (April 2010 to March 2011) was patched together by means of a balancing act. Following through on the pledge by the ruling Democratic Party of Japan to shift the emphasis "from concrete to people," the government made deep cuts in public investment while stepping welfare spending up, although not to the extent originally proposed. Japan's public finance has deteriorated too far for concealment, and one of the rating agencies has warned it may lower Japan's current rating, changing the outlook from stable to negative.

Such are the circumstances we at the Japan Center for Economic Research (JCER) took into account when we updated our forecast for the Japanese economy (see the table). Over the period to the end of fiscal 2011, we see the Japanese economy as in a recovery led by external demand, but it is expected to proceed gradually without gathering much momentum. The first half of 2010 will be a period of "fiscal vacuum," meaning that cuts in public investment are being introduced first, with a policy lag before the new child allowance and other measures to redistribute income fully kick in, but concern about reaching a plateau in the economic cycle has diminished. With emerging markets set to play the role of the leading actor, we have revised upward the forecast we had made three months ago. The growth rate should increase to a reasonable speed during fiscal 2010 and fiscal 2011, but there will be no basic change in the low level of economic activities and the presence of deflationary pressures.

As in the case of previous upturns, exports will lead the way, and corporate earnings and fixed investment will follow as a virtuous circle quietly takes hold. This will be a recovery that fails to gain much vigor, however, as private domestic demand will lack power due to the following reasons.

First, companies will keep a cautious stance to plant and equipment investment. Figure 1 shows the judgment among major manufacturing corporations regarding whether they have too many or too few production facilities and workers, gathered in the Tankan survey. At present they are more concerned about an excess of facilities than that of employees. This is an unusual reversal of the pattern in the past, and it suggests that capital investment went too far during the last economic expansion, which I call the "Dejima expansion," starting in early 2002 and ending in the final quarter in 2007. (Named after Nagasaki's island of Dejima, Japan's window to the world during the period of national seclusion, the expansion lasted longer than the Izanagi boom of the late 1960s.)

Figure 1. Production Capacity and Employment Condition (Large Manufacturers)




Source: Bank of Japan, "Tankan" (Short-term Economic Survey of Enterprises in Japan)

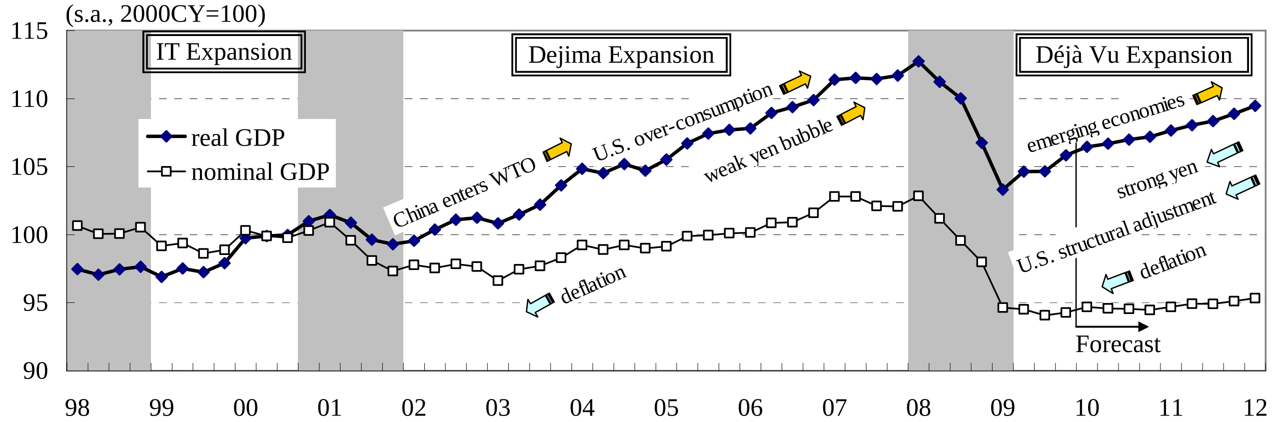
With hindsight, this overinvestment in plant and equipment was justified on the condition of excess consumption in the United States and the “weak-yen bubble” that long supported Dejima exporters.

Second, the household sector will once again be left behind in the business upturn. Because companies will stick to a stance of holding down personnel costs as they rush to regain healthy earnings ratios, the share of corporate income passed on to labor will probably decline. Under the circumstances, the severe employment and income condition facing the household sector will not change. The child allowance and other government measures to transfer income to households cannot be expected to generate much additional consumption, as they will be used up in efforts to sustain living standards, or otherwise will be saved.

The above-mentioned features of business resemble what occurred in the Dejima expansion. This means we will also see a rekindling of the arguments over the disparities in the sense of prosperity separating the corporate and household sectors, urban and rural areas, manufacturing and nonmanufacturing industries, and large and small companies. Each is an issue that the current government criticized while it was in the opposition. On witnessing deflation take root and department store outlets shut down even as they worry about the downgrading of government bonds, many people will no doubt find themselves recalling Japan’s experience in the early 2000s expansion and getting the feeling of déjà vu. Indeed, the ongoing recovery phase may even merit the name of the “déjà vu upturn.”

As figure 2 indicates, Japan’s economy will be treading an uphill path. External demand will again lead the way, but the recovery road will be tough. For a number of reasons the going is likely to be even rougher than it was last time. First, the ascent will be impeded by a headwind. In place of

Figure 2. Real and Nominal GDP




Note: The latest business-cycle trough is provisionally depicted as 2009Q1.
Source: Cabinet Office, "Quarterly Estimates of GDP"

the weak-yen bubble, a strengthening yen will worsen the climate for exports and corporate profits. Second, there will be stiff competition with other countries' climbers for increasing demand from the emerging economies' middle-income consumers. South Korean companies have been taking great strides in this area with not only an assist from the comparative advantages of a weak won, but considerable technological prowess, and finely honed management strategies. On top of that, Japanese companies must struggle under the handicap of the Japanese government's delay in concluding free trade agreements (FTAs). Third, Japanese climbers will be shouldering rucksacks made heavy by structural problems. Our country is in a fiscal pinch even worse than that of Greece, and the aging of the population is progressing rapidly with a decline in the number of children.

Quite a few cliffs lie ahead on the challenging and narrow trail. Deteriorating external conditions could derail the recovery immediately. U.S. economy faces various structural problems accumulated through the last expansion, such as balance-sheet adjustments in household budgets, and it has been unable to regain its normal power for some time. Trends in the American housing market bear watching: at the end of March the Federal Reserve plans to cease its program of purchasing mortgage-backed securities.

The euro area is moving into a time of trial. Policy management will be difficult because the European Union's members are at different places in the business cycle. Quite a few countries, including Greece, have been forced to opt for austerity even though their businesses are in fragile shape. China faces only small short-term risks, although its prospects over the medium- or longer term are a separate matter. For the time being the Chinese government will aim at fairly fast growth while deploying an array of policy tools to prevent overheating. One of the policy options is to guide the renminbi higher.

International financial markets have no lack of destabilizing factors. Apart from the issue of the yuan's value, there is the risk of "another Greece" turning up as the market weeds out winners and losers in the emerging economies. The speculation on how and when the FRB will exit its current ultra-easy monetary policy, the leading actor creating market liquidity, could destabilize international money market. The United States is moving into a political season. Recent bilateral friction between the United States and China and the gradually dwindling momentum in the field of international cooperation are another concerns to be watched.

The investment behavior of Japanese companies is the foremost component of the uncertainty at home. Even if the will to invest recovers among entrepreneurs, questions remain about whether investments will be made within Japan. In the strong-yen climate, many people fear that industrial hollowing may advance if major manufacturers—reacting badly to the antibusiness measures the government is contemplating, such as banning the dispatch of temporary workers to manufacturing jobs—move operations offshore. Smaller manufacturers cannot easily relocate to other countries, and they would suffer a double punch from the loss of orders and the prolongation of deflation.

What should be done to turn the déjà vu upturn into a solid expansionary phase? Actually a three-cornered deadlock has taken hold among companies, households, and the government. Suppose households were urged to expand consumption. This would undoubtedly elicit immediate protests from the household sector, with family members insisting that the first order of government should be relieving anxieties about the future. As for what the corporate sector should do, many people are firmly convinced that it should change the way it distributes earnings by backing away from its shareholder-first orientation and awarding workers a bigger slice of the pie. But corporate executives would flatly reject such a request, arguing that the first need is to correct overly generous wages and the inflexible labor market. And if companies were asked to channel investment into moves to strengthen competitive power, surely their bosses would reply that a more important need is lowering Japan's overly high corporate tax rate. Meanwhile the government, finding itself under attack, would reject any call for tax cuts, saying that the fiscal situation does not allow it to reduce taxes. It would further inform the public that before hiking taxes, it planned to eliminate wasteful spending in response to requests from the household sector.

In order to lift the sense of helplessness stemming from this three-cornered deadlock, which has hobbled companies, households, and the government, the political leadership must reach the decision to hike the consumption tax from its present 5%. Government expenditures are becoming increasingly inflexible because of the graying of Japanese society and the spending on such measures as the child allowance, while revenue relies heavily on income taxes, causing it to move up and down with the business cycle. The time has come for quick action to make the consumption tax a bigger source of revenue, thereby relieving worries about pension benefits and enabling cuts in corporate taxes which are higher than the international standard.

Only by moving in this direction will the government be able to convince corporate executives to step forward by plowing money into investments and persuade families that “consumption is virtuous.” At the same time, private-sector actors must agree to climb the recovery trail on their own power instead of relying on the state. The role of government must be limited to assisting those who are unable to hike without help and rescuing others who fall from cliffs, thereby deploying a safety net that gives all who need it a second chance to rise to the challenges before them.

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## Table. The Outlook for Japanese Economy

Forecast →

| | FY2009 1st Qtr | 2nd | 3rd | 4th | FY2010 1st Qtr | 2nd | 3rd | 4th | FY2011 1st Qtr | 2nd | 3rd | 4th | FY2008 Actual | FY2009 Forecast | FY2010 Forecast | FY2011 Forecast |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real gross domestic expenditures (qtr.-to-qtr.) | 1.3 | 0.0 | 1.1 | 0.6 | 0.2 | 0.3 | 0.2 | 0.4 | 0.4 | 0.3 | 0.5 | 0.5 | -3.7 | -2.3 | 1.7 | 1.4 |
| Real gross domestic expenditures (year-on-year) | -5.7 | -5.2 | -0.4 | 3.0 | 2.0 | 2.2 | 1.3 | 1.1 | 1.3 | 1.3 | 1.6 | 1.7 | | | | |
| Private final consumption (qtr.-to-qtr.) | 1.1 | 0.6 | 0.7 | 0.3 | 0.2 | 0.4 | 0.2 | 0.2 | 0.2 | -0.1 | 0.1 | 0.2 | -1.8 | 0.5 | 1.4 | 0.5 |
| Private housing investment (qtr.-to-qtr.) | -9.4 | -7.8 | -3.4 | 0.6 | 1.2 | 1.3 | 1.3 | 1.3 | 0.5 | 0.5 | 0.7 | 0.8 | -3.7 | -18.4 | -0.2 | 3.5 |
| Private non-residential investment (qtr.-to-qtr.) | -4.2 | -2.5 | 1.0 | 0.5 | 0.6 | 0.6 | 0.7 | 0.7 | 0.9 | 1.0 | 1.1 | 1.1 | -6.8 | -16.0 | 1.8 | 3.5 |
| Public fixed capital formation (qtr.-to-qtr.) | 6.4 | -1.6 | -1.6 | -1.3 | -4.1 | -5.7 | -3.8 | -2.3 | 0.7 | 0.9 | 1.1 | 1.3 | -6.6 | 7.1 | -12.4 | -3.0 |
| Domestic demand (contribution) | -0.5 | -0.3 | 0.6 | 0.3 | 0.1 | 0.2 | 0.1 | 0.2 | 0.2 | 0.1 | 0.3 | 0.3 | -2.5 | -2.0 | 0.8 | 0.8 |
| Net exports of goods and services (contribution) | 1.8 | 0.3 | 0.5 | 0.2 | 0.1 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.2 | 0.2 | -1.2 | -0.3 | 0.8 | 0.6 |
| Exports of goods and services (qtr.-to-qtr.) | 9.2 | 8.4 | 5.0 | 3.3 | 2.1 | 1.8 | 1.7 | 2.0 | 1.8 | 2.1 | 2.7 | 2.3 | -10.4 | -11.0 | 12.2 | 8.3 |
| Imports of goods and services (qtr.-to-qtr.) | -3.9 | 5.4 | 1.3 | 2.2 | 2.2 | 1.7 | 1.8 | 1.0 | 1.3 | 1.6 | 1.8 | 1.7 | -4.2 | -12.2 | 8.5 | 6.0 |
| Nominal gross domestic expenditures (qtr.-to-qtr.) | -0.1 | -0.5 | 0.2 | 0.4 | -0.1 | -0.0 | -0.1 | 0.2 | 0.2 | -0.0 | 0.2 | 0.2 | -4.2 | -4.0 | 0.2 | 0.5 |
| Indices of Industrial Production (qtr.-to-qtr.) | 8.3 | 7.4 | 4.5 | 3.6 | 1.1 | 0.8 | 0.6 | 0.8 | 0.8 | 1.0 | 1.7 | 1.6 | -12.7 | -9.6 | 9.2 | 4.0 |
| Unemployment rate (%) | 5.2 | 5.5 | 5.1 | 5.1 | 5.1 | 5.1 | 5.0 | 4.9 | 4.9 | 4.8 | 4.7 | 4.5 | 4.1 | 5.2 | 5.0 | 4.7 |
| Compensation of employees (qtr.-to-qtr.) | -1.8 | -0.0 | -1.2 | -0.2 | -0.2 | 0.1 | -0.3 | 0.1 | 0.1 | 0.2 | 0.1 | 0.3 | -0.3 | -4.0 | -1.1 | 0.3 |
| Newly issued government bonds yield 10-years (%) | 1.447 | 1.344 | 1.312 | 1.337 | 1.368 | 1.398 | 1.428 | 1.459 | 1.504 | 1.550 | 1.595 | 1.641 | 1.459 | 1.360 | 1.413 | 1.573 |
| Nikkei Stock Average (yen) | 9,302 | 10,129 | 9,969 | 10,356 | 10,741 | 11,129 | 11,171 | 11,408 | 11,765 | 12,121 | 12,477 | 12,834 | 10,860 | 9,939 | 11,112 | 12,299 |
| Yen : Dollar exchange rate (yen / dollar) | 97.3 | 93.7 | 89.7 | 90.5 | 93.1 | 94.0 | 94.0 | 95.3 | 96.4 | 97.4 | 98.4 | 98.6 | 100.6 | 92.8 | 94.1 | 97.7 |
| WTI Crude oil price (dollar / barrel) | 59.8 | 68.2 | 76.1 | 75.4 | 76.9 | 78.5 | 79.8 | 80.4 | 80.4 | 80.4 | 80.4 | 80.4 | 86.6 | 69.9 | 78.9 | 80.4 |
| Domestic corporate goods price index (year-on-year) | -5.5 | -8.3 | -5.2 | -1.9 | -0.7 | -0.8 | -0.2 | -0.4 | -0.4 | -0.4 | -0.4 | -0.4 | 3.1 | -5.3 | -0.5 | -0.4 |
| Consumer price index (excluding fresh food ; year-on-year) | -1.0 | -2.3 | -1.8 | -0.8 | -1.3 | -1.0 | -0.7 | -0.8 | -0.3 | -0.3 | -0.5 | -0.4 | 1.2 | -1.5 | -0.9 | -0.4 |
| Current account / Nominal GDP (%) | 3.3 | 3.2 | 3.2 | 2.9 | 2.8 | 2.6 | 2.4 | 2.4 | 2.3 | 2.3 | 2.3 | 2.4 | 2.5 | 3.3 | 2.7 | 2.5 |
| Real GDP of U.S.A. (qtr.-to-qtr.) | -0.7 | 2.2 | 5.7 | 2.3 | 2.6 | 2.0 | 2.1 | 2.2 | 2.6 | 2.9 | 3.3 | 3.2 | 0.4 | -2.4 | 2.7 | 2.4 |
| Real GDP of China (year-on-year) | 7.9 | 9.1 | 10.7 | 12.5 | 9.8 | 9.9 | 8.0 | 8.9 | 9.1 | 9.5 | 9.8 | 9.8 | 9.6 | 8.7 | 9.8 | 9.4 |
| | | | | | | | | | | | | | (C.Y.) | (C.Y.) | (C.Y.) | (C.Y.) |

[Notes] 1. Figures are shown in percentage changes, and contribution means contribution to real GDP growth.
2. Figures for GDP components are at chained (2000) yen.
3. Figures for consumer price index, domestic corporate goods price index and indices of industrial production are at 2005 year basis.
4. Figures for GDP components, Compensation of employees, unemployment rate, indices of industrial production and current account are seasonally adjusted.
5. Figures for real GDP of U.S.A. are seasonally adjusted annual rates, at chained (2005) dollars.
6. Japan's fiscal year is April 1 to March 31.
7. Figures for Long-term interest rates, Stock price, Oil price, Exchange rate, and Unemployment rate are shown in average terms for corresponding periods.



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